

***United States Court of Appeals
for the Second Circuit***



**BRIEF FOR
APPELLANT**

76-6093

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P/S

United States Court of Appeals
FOR THE SECOND CIRCUIT

LE BEAU TOURS INTER-AMERICA, INC.,

Plaintiff-Appellant,

against

UNITED STATES OF AMERICA,

Defendant-Appellee.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF FOR PLAINTIFF-APPELLANT

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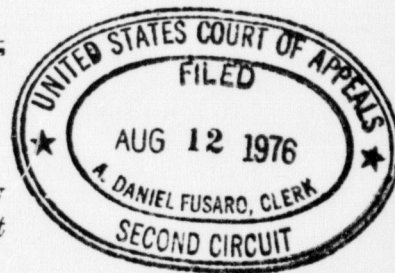


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PRELIMINARY STATEMENT

This is an appeal from a judgment by the Hon. Lee P. Gagliardi, D.J., granting summary judgment to appellee United States of America (A 73).

THE ISSUES PRESENTED

The sole legal issue presented is:

Was 95% or more of taxpayer's gross income derived from sources without the United States so as to qualify taxpayer as a Western Hemisphere Trade Corporation ("WHTC") under §921, I.R.C.?

Subliminally the case is permeated with the issue whether taxpayer has availed itself of the tax benefits of §921, I.R.C., in a manner which is sham and contrary to public policy.⁽¹⁾

STATEMENT OF THE CASE

1. The Nature of the Case

This is a tax refund claim for the years 1966, 1967 and 1968. For each of the years taxpayer filed income tax returns and paid income taxes on the basis of being entitled to the reduced tax rates applicable to a WHTC. The Commissioner disallowed this tax benefit and assessed additional income taxes, which were paid by taxpayer. Taxpayer now sues for refund of these additional tax payments plus interest.

(1) The WHTC legislation grew out of "a desire to encourage special tax breaks for businesses engaged in the development of the Western Hemisphere" Silbert, 31 N.Y.Inst. Fed. Taxation 721,724 (1973). It is one of several export promoting inducements contained in the Internal Revenue Code. A WHTC is entitled to a deduction which may reduce the applicable income tax by as much as 14 percentage points or nearly 37% below the ordinary corporate income tax. For a historic review see Tepper & Lotterman, The Federal Tax Inducements to Western Hemisphere Trade, 31 Cornell L.Q. 205 (1945). See also Otis Elevator Co. v. U.S., 301 F 2d 320 (Ct.Cl.1962) at 326. Feinschreiber Tax Incentives for Exporters, Pg. 1

This is a case of first impression under §921, I.R.C., and its predecessor statute §109 of the 1939 Code, because previous decisions about the WHTC dealt with corporations which are engaged in the export or import of merchandise. There does not seem to be any previously reported case where a travel agency or other service business has availed itself of the tax benefit offered by Congress to a WHTC.

2. Proceedings and Disposition Below

In the District Court the parties filed a stipulation of agreed facts (A 43) and cross-moved for summary judgment. The District Court (Gagliardi, J) denied both motions because it discerned a triable issue of fact with respect to the source of taxpayer's gross income (§921, Item 1, I.R.C.). The court below wanted to hear evidence as to how much of taxpayer's gross income was allocable to sources within the U.S. and how much to sources without the U.S. In a first opinion the court below (A 56) stated that the activities performed at its corporate headquarters in New York by taxpayer and its affiliate, Le Beau Tours, must be allocated to sources within the United States and that the functions performed by taxpayer's ground operators abroad must be disregarded. Maintaining that none of its income was derived from sources within the United States, taxpayer readily conceded that the time spent in New York by personnel of the Le Beau Tours and by plaintiff's officers exceeded 5% of the activity related to taxpayer's business and it was so stipulated in a second stipulation filed below (A 68). The parties thereupon renewed their cross-motions for summary judgment. The District Court then awarded summary judgment to the Government by the judgment from which this appeal is taken (A 73).

3. Facts

The undisputed facts can be summarized as follows:

Taxpayer is a domestic corporation which was organized in order to take over and expand the travel business in the West Indies, Central and South America theretofore conducted by Le Beau Tours ("Tours"). The avowed purpose of the organization was to take advantage of the tax benefits granted to a WHTC by §921, seq. I.R.C. The stockholders, directors and officers of taxpayer are identical with those of Tours, both companies are therefore in the category of affiliates. Taxpayer has its headquarters at the office of Tours in New York. All administrative and promotional services of taxpayer in the United States are rendered by personnel of Tours which, in the years under review, included the officers of the taxpayer. Taxpayer kept separate corporate records and filed separate tax returns. Taxpayer paid Tours for its services. The amount of such payment is not an issue in this case. In most instances taxpayer does not deal directly with the American tourists but through so-called retail travel agents. For brevity and substantial clarity, this distinction is disregarded in the following discussion. For the same reason we ask the Court to disregard that the District Court overlooked that taxpayer was organized in 1962 (A 11) and not in 1966 as stated in the first opinion (A 58). The District Court assumed, and the parties implicitly stipulated, that the situation in regard to source of income in the three years immediately preceding the close of the taxable years under review was not different from that in 1966, 1967 and 1968.

Taxpayer meets the requirement of §921(2) of I.R.C. in that 90% or more of its gross income is derived from the active conduct of trade or business in the Western Hemisphere which includes the U.S. (hereafter called the "activity test"). The activity of taxpayer consists of the following:

Taxpayer develops contacts with hotels and so-called ground operators in the West Indies, Central America and South America. Ground operators are firms which operate buses and taxis and furnish guides or escorts. Taxpayer also established office facilities in these foreign countries at which American tourists can obtain assistance when needed. In 1966 taxpayer maintained office facilities in San Juan, Puerto Rico; St. Thomas, Virgin Islands; Christiansted, Virgin Islands; Kingston, Jamaica; Mexico City; Nassau, Bahamas; Freeport, Bahamas; St. Johns, Antigua; Bridgetown, Barbados; Port of Spain, Trinidad. In 1968, office facilities were added in Rio de Janeiro, Brazil; Lima, Peru; Santiago, Chile and Buenos Aires, Argentina.

Having made these arrangements abroad, taxpayer in New York then develops so-called package tours which are offered to American tourists, mostly through retail travel agents. The administrative and promotional work is done by personnel of Tours in New York for which work taxpayer pays Tours. Taxpayer's gross income is derived from the foreign hotels and ground operators from whom taxpayer receives an agreed-upon commission on all bookings which it obtains from American tourists. The price to the American tourist is the same regardless whether he books directly or through taxpayer. Payment of taxpayer's commissions is generally effectuated by taxpayer withholding the commission

due it from the amount it collects from the American tourists for the foreign accommodations. An analysis of the income tax returns under review (A 17, 21, 25) shows the following:

1966: Collected from Tourists	\$ 1,591,144.79
Gross Commissions Withheld	260,200.25
Remitted to Foreign Hotels, etc.	<u>\$ 1,330,944.54</u>
1967: Collected from Tourists	\$ 2,082,615.23
Gross Commissions Withheld	439,559.04
Remitted to Foreign Hotels, etc.	<u>\$ 1,643,056.19</u>
1968: Collected from Tourists:	\$ 2,392,094.81
Gross Commissions Withheld	311,757.42
Remitted to Foreign Hotels, etc.	<u>\$ 2,080,337.39</u>

In order to avoid the appearance of a misleading statement it must be pointed out that the phrase "Remitted to Foreign Hotels, etc." does not appear on the taxpayer's tax returns. In these returns, the accountant who prepared the returns categorized this items as "Cost of Goods Sold" because Tax Form 1120 did not seem to provide another suitable category. This peculiar nomenclature in Tax Form 1120 does not alter the substance of the transactions, as we pointed out below, without contradiction. The Tax Form nomenclature has no bearing on the issue raised by this appeal, which is whether the stated amounts of gross income are from sources without the United States. (The Tax Returns for 1967 and 1968 show interest income. Taxpayer invested excess funds in the Virgin Islands, - hence the interest is from sources without the U.S. I.R.S. has not challenged this and it is not a matter of record.)

ARGUMENTI. - Summary

Taxpayer is a purchasing agent for American tourists desiring to travel to Western Hemisphere countries south of the United States border. The services consist of establishing, outside the U.S., a network of hotels, ground operators, guides and office facilities and offering American tourists the use of this network by means of so-called 'package tours'. These services are compensated by the foreign hotels and ground operators -- the purchasing American customer does not pay any compensation for taxpayer's services. Regardless who pays for the services, the situs of the services is abroad and, therefore, all of taxpayer's gross income is derived from sources without the United States within the meaning of Item 1 of §921, I.R.C.

The sole difference between export merchants using the WHTC tax benefit and the instant taxpayer is that the merchants transfer goods to the Western Hemisphere while taxpayer transfers tourists to the Western Hemisphere.

II. - THE DISTRICT COURT ERRED IN ALLOCATING
ANY OF TAXPAYER'S GROSS INCOME TO SOURCES WITHIN
THE UNITED STATES.

It is not clear whether the District Court recognized the distinction between gross receipts and gross income. The sums which taxpayer collects from the American tourists are gross receipts. These are payable to the foreign hotels and ground operators and in the nature of pass-through items, as more fully discussed below.

(Page 17 |). The gross income consists of the commissions due tax-

payer which taxpayer withholds before remitting the gross receipts to the foreign hotels and ground operators. From this gross income taxpayer pays its expenses, the principal item of which is the payment for the administrative services rendered by Le Beau Tours.

The basic error of the District Court is its attempt to allocate taxpayer's income between sources within and sources without the United States. This error is compounded by a number of factors.

(a) The apparent authority for such allocation are the provisions of §861, I.R.C., seq. The WHTC regulations refer to the regulations for §861, seq. These sections were enacted to limit U.S. tax liability of non-resident aliens to income from sources within the U.S., a purpose entirely unrelated to the purpose of the WHTC. These sections offer no exclusive guidelines for all sources of income situations. Rev. Ruling 70-304.

(b) Assuming, however, for argument's sake that §861, seq., are applicable in the instant case, it must be noted that they prohibit allocation in the instant case. §861 deals with income from sources within and §862 deals with income from sources without the U.S. §862 covers the instant case by including:

"3. compensation for labor and services performed without the United States."

§863 deals with items not specified in §861 or §862, and it authorizes allocation only in respect to such unspecified items. The notion that taxpayer's unitary Western Hemisphere business can be partitioned in

two diverse sources is unacceptably artificial. As §862(a)(3) specifies taxpayer's compensable services, there is neither room nor authority to allocate income.⁽²⁾

(c) The District Court was misled into allocating income because it thought that the activities at taxpayer's corporate headquarters in New York and the activities of taxpayer's affiliate, Le Beau Tours in New York, contributed to the generation of taxpayer's gross income. This misconceives the significance of the source of income concept. The law does not look for the first or any of several subsequent causes which contribute to the creation of income. What counts is the last cause. It matters not what or who contributed to the generation of a taxpayer's income.⁽³⁾ The source of income concept is authoritatively set out in Com. v. Piedras Negras Broadcasting Co., 127 F 2d 260 (CA-5, 1942). In that case, two Americans organized a Mexican corporation and established a broadcasting station in Piedras Negras, across the Rio Grande River.

(2) Reg. 1-861-4 assumes (with dubious legal authority) that income from sources within the U.S. may be allocated. These regulations aim apparently at non-resident aliens who work as seamen or ballplayers for an American employer. Rev. Rul. 76-66; Rev. Rul. 74-108. The regulations also suggest an arbitrary distinction between the periods prior to and after January 1, 1976. For the former, the regulations propose an allocation on a time spent basis. Conceivably the District Court had this in mind, although it did not say so. If that should be the case the manifest error was to assume that there was any income from sources within the U.S. which warranted apportionment. Moreover, while the suggested apportionment on a time basis may be a suitable guideline for dealing with non-resident aliens, ballplayers or seamen, it certainly is inappropriate for a WHTC, where the proportion of time spent does not necessarily reflect the proportion of value or profit created.

(3) British Timken Limited v. Com., 12 T.C. 880 (1949) at p. 887.

from Eagle Pass, Texas. The main business of the Mexican broadcasting station was to sell radio time to American advertisers of American goods. Advertisers were solicited through agents in the United States. The American advertisers paid the Mexican corporation generally on a percentage of sales basis, and payment was made at Eagle Pass, Texas. The Commissioner asserted that these payments were taxable as income from sources within the United States because they came from the American advertisers. The Court ruled to the contrary, confirming the Board of Tax Appeal in its holding that the income was from sources without the United States, from where the broadcasting service emanated. Said the Court: "the source of the income is the situs of the income producing services". Solicitation of customers was not regarded as income producing service.

In the instant case, like in Piedras Negras:

- 1) solicitation of customers took place within the U.S.;
- 2) the paying customers were located in the U.S.;
- 3) the source of gross income was the supply of services without the U.S. In Piedras Negras, these services consisted of sending radio programs. In the present case the services consisted of arranging abroad for a packaged combination of hotel accommodations, ground transportation, escort services and assistance offices.

The District Court failed to recognize, or it obliterated, the distinction between the activities test of Item 2 of §921, I.R.C. and the source of income test of Item 1 of §921. To qualify as a WHTC, a corporation must be a domestic corporation (§921, I.R.C.) which means that it must maintain its principal office in the United States. Nowhere in the statute, the regulations, the decisional law, or the literature is there any indication that the activities at the corporate headquarters must be limited to less than 95% of the total corporate activities.

III. - THE DISTRICT COURT FAILED TO
RECOGNIZE THAT THE SOURCE OF INCOME TEST OF
§921, I.R.C., IS LINKED TO ECONOMIC REALITIES.

The source of income test has caused considerable trouble to foreign traders, many complaints about the draftsmanship of Congress, and much litigation.⁽⁴⁾ The Internal Revenue Code contains no definition of what is meant by source of income. The Regulations (1.921-1) refer back to §861, seq., I.R.C., which were written to circumscribe the tax liability of non-resident aliens and have no utility for the present case, nor do the Regulations for §861, seq., offer any guidance.⁽⁵⁾ Thus, the courts are required to use the source rule according to the economic realities of each case or group of cases.

(4) See Rapp Western Hemisphere Corporations. Proc. of N.Y. Seventh Annual Inst. on Fed. Taxation p. 1405 (1949); Tepper and Lotterman, 31 Cornell L.Q. 205, 211.

(5) Rev. Rule 70-304 points out that §861, seq., I.R.C., and the regulations thereunder do not cover all cases of foreign source income and that therefore determination of foreign source income at times requires resort to general principles of law.

A frequently used non-statutory maxim is that the source of the income is the place where the compensable services are rendered. This is a rather simplistic and mechanical generalization which stems from the superseded Treasury Regulation 111 §29.119-4. This court has on previous occasion cautioned against rigidity in the use of the source of income test.⁽⁶⁾

In case of a non-resident alien employee, it is easy to conclude that the place where he works and renders services is the source of his income.

A more complex application of the source rule arose in the recent case of Uno Lamm, T.C.Memo 1975-95. An American resident was required to pay alimony to his ex-wife, a resident of Sweden. The taxpayer made the payment from a bank account which he maintained in Sweden. For withholding tax purposes the question arose whether these alimony payments from the Swedish bank account were made from sources within or without the United States. The Tax Court ruled that the payments from the Swedish bank account were from sources within the U.S. because the locus of the debt is in the U.S. The Tax Court had previously made a similar ruling in Howkins, 49 T.C. 689 (1968) declaring payment from an English bank account as from sources within the U.S.

If a Domestic International Sales Corporation (DISC) §991, I.R.C.,⁽⁷⁾ pays a dividend to its domestic parent corporation, the parent is to treat such dividend from a domestic corporation as from "sources without the United States". Rev. Rul. 73-68. A domestic airline company

(6) U.S. v. Balanovski, 236 F 2d 298, 306 (CA-2, 1956). Cert. den. 352 U.S. 968; ren. den. 352 U.S. 1019 (1957).

(7) Like the WHTC, the DISC was created by Congress in order to grant incentives for the generation of income from sources without the U.S. Feinschreiber, Tax Incentives for U.S. Exports.

received an airmail subsidy from the Federal Government because it flew over a route wholly outside the U.S.A. The Government subsidy for this service was held to be income from sources without the U.S. Rev. Rul. 63-269. These three illustrations will suffice to show that the application of the source of income test requires more sophistication than may have been apparent to the District Court. In each case, it is necessary to probe for the economic reality of the situation. (8)

In the instant case, the heart of the service rendered by the taxpayer is the "packaging" of a tour to the Western Hemisphere, consisting of putting together the hotel accommodations, ground transportation by bus or taxi, escort services and assistance accommodation in offices abroad. The economic burden of the service abroad is born by the foreign hotels and ground operators because the compensation paid to taxpayer comes out of the price which the tourist pays. The Court will take judicial notice of the fact that it is common practice for the American travel agent not to look for compensation to the traveler. If an American traveler buys an airplane ticket, the price to him is the same whether he buys directly from the airline or whether he buys through a travel agent. In the latter case the travel agent, although acting for the traveler, receives a commission from the airline. It must be noted that taxpayer does not include any air or sea travel in its package (A 12, 34) which would yield to it gross income from sources within the United States, namely, a commission from the domestic carrier. Taxpayer's business is limited to services which produce gross income from sources without the United States.

(8) An excellent example for this approach is found in the U.S. Tax Court opinion British Timken Ltd. v. Com., 12 T.C. 880 (1949).

The phenomenon that an agent is not compensated by his principal but by the third party with whom the agent deals on behalf of his principal is not confined to the travel industry. It occurs also in the advertising business and the insurance industry. The businessman who requests his advertising agency to place an advertisement in a magazine, does not expect to pay his agent; the agent is paid a commission by the magazine publisher.⁽⁹⁾ In the case in which an insurance broker acts as agent for the insured, it is not the insured principal but the selling insurance company who pays the commission to the agent.⁽¹⁰⁾

Reg. 1.861-4 which deals with the source of income for labor or service by non-resident aliens and which might be given some weight because Reg. 1.921-1 refers to §861 I.R.C. ⁽¹¹⁾ states that the residence of the payor is not controlling for the determination of the source of gross income. It could therefore be said that it is immaterial in the context of the present case that the hotels and ground operators reside abroad. What really determines the source of taxpayer's income is the situs of the services being paid for.

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- (9) Advertising Agency as agent of advertising medium or of advertiser.
53 ALR 2d, 1139, 1140.
- (10) Appleman Insurance Law (Revised Volume 16, 1968, §8722).
- (11) A misleading reference. See Rev. Rul. 70-304 as discussed footnote 5, supra.

IV. - THE SOURCE OF INCOME IS THE SITUS
OF THE COMPLETION OF THE TRANSACTION WHICH GIVES
RISE TO THE INCOME

In order to determine the source of income, it is necessary to ascertain the place where the compensable transaction is completed. It is common practice, as sanctioned by the courts, for American manufacturers to organize in-house subsidiaries to which they transfer their products for export to Western Hemisphere countries other than the U.S. (12) The gross income, the source of which is significant for qualification under §921, I.R.C., are the sales proceeds, regardless of the fact that the product has been manufactured by the parent and that the staff of the parent has performed administrative work for the WHTC. (13) Were it not so the very purpose of the WHTC legislation would be frustrated. The District Court erred in drawing any adverse inference from the fact that administrative work of taxpayer was performed at its corporate headquarters in New York by personnel of Le Beau Tours. If personal property is sold, the source of the income is the place where the sale is made. Over repeated objections of the Commissioner, the courts have established the firm rule that the place where title passes is the place where the sale is made and, hence, that place is

(12) Feinschreiber, Tax Incentives for U.S. Exporters. p. 68

(13) Com. v. Pfaudler Inter American Corp., 330 F 2d 471 (CA-2, 1964)
Frank v. Int'l. Canadian Corp., 308 F 2d 520 (CA-9, 1962)
Com. v. Hammond Organ Western Export Corp., 327 F 2d 974 (CA-7, 1964)
 These decisions are discussed below p. 21 seq.
 "Under §119 [of the 1939 Code, predecessor of §921] the process of manufacture is regarded as an income producing factor and the situs of the manufacturing is deemed the source of the resulting income. The purchase, however, of commodities or goods, as distinguished from the manufacture or production, is not considered an income producing factor. And the profits realized upon a resale are deemed to have been earned in the country where the merchandise has been sold." Tepper and Lotterman, *supra*. at p. 218 (underlining supplied).

the source of income for purposes of §921, I.R.C. (14) The rationale of this rule is that passage of title indicates completion of the transaction. It is not enough that the U.S. exporter ships the merchandise to the foreign country. Similarly, it is not enough if taxpayer, or its office abroad, makes a booking with the foreign hotel or ground operator. The foreign recipient of the booking request must perform, must furnish accommodations, ground transportation, etc. ... Only when this has occurred has plaintiff earned its compensation and only then is the transaction completed. It is axiomatic that hotel bookings are subject to confirmation by the hotel. Since that crucial event occurs abroad, the source of the taxpayer's income is from sources without the United States.

This aspect of the source of income rule is illustrated by two Treasury Rulings, both involving the payment of a U.S. Government subsidy to a domestic corporation which claimed the WHTC privilege. Rev. Ruling 68-497 involved an export subsidy under the Cotton Products Export Regulations. The ruling concluded that "since all conditions under which the equalization payments were granted were fulfilled within the United States, equalization payments ... constitute income from sources within the United States ...". (underlining supplied) In contrast, Rev. Ruling 63-269 dealt with a U.S. subsidy payment to a domestic airline which flew its planes over a route lying entirely outside the United States. The conclusion here was that the subsidy constituted income from sources without the U.S., since the conditions under which

(14) Com. v. Pfaudler Inter-American Corp., 330 F 2d 471 (CA-2, 1964): The leading case for the title passage test is Com. v. East Coast Oil Co., 85 F 2d 322 (CA-5, 1936), cert. den. 299 U.S. 608 (1936) discussed infra p

the subsidies were granted were complied with without the U.S.

In the case at bar, taxpayer would not have received any income had it not assembled and supplied the accommodations and other described services outside the United States.

V. - THE SOURCE OF THE INCOME IS
THE PLACE WHERE THE INCOME IS EARNED.
TAXPAYER EARNED ITS INCOME ABROAD.

The place where the taxpayer earns the income is the source of the income.⁽¹⁵⁾ Com. v. East Coast Oil Co., 85 F 2d 322 (CA-5, 1936) cert. den. 299 U.S. 608 furnishes a good illustration of this concept. A Mexican corporation sold oil to customers in the U.S.A. on an f.o.b. or c.i.f. Mexican port basis. The Commissioner claimed that the sales profits were from sources within the U.S. In rejecting the Commissioner's contention, the court stated at p. 323:

"It is further contended by the Commissioner that as the sales were negotiated in the United States and payment was made here, the income was derived from sources within the U.S.

. . .

"In this case, the important question is when and where were the profits earned ... No profit resulted from the mere execution of the contracts. The oil was delivered to the buyer in Mexico. The title passed to the buyer in Mexico. When title passed, the profit was earned in Mexico. Collection of the price in the United States was incidental and did not earn the profit." (underlining supplied)

(15) This is the basis of Rev. Rul. 63-269. Feinschreiber, Tax Incentives for U.S. Exporters, p. 7, says that the gross income need not even be earned in the Western Hemisphere, which he believes to be the result of a drafting error.

In the instant case the District Court may have been led astray by the fact that the moneys constituting taxpayer's gross income are taken from the funds which taxpayer collects from the American tourists. As pointed out above, this is merely a convenient mechanism for paying taxpayer's compensation. An alternative method, which would not change the substance of the transaction, would be for taxpayer to remit all funds to the foreign hotels and ground operators, and for them to send taxpayer a commission check. Such check could be drawn on a bank in the payor's home country or on a bank account which payor maintains in New York. In the latter case, the Commissioner might have advanced the erroneous argument that the income came from a source within the U.S., namely, a New York bank. Such or similar mechanical tests are at war with the law, which looks at what is really happening.

When the American tourist responds to the promotional activity of taxpayer in New York by retaining taxpayer as purchasing agent for the procurement of accommodations abroad, and when he deposits the cost of these accommodations he does not intend to nor does he in fact compensate the taxpayer. It is immaterial for the determination of source of income where the contract or the contact is made,⁽¹⁶⁾ what method of payment is used or who writes the check.⁽¹⁷⁾ It is established law that the source

(16) Com. v. East Coast Oil Co., 85 F 2d 322 (CA-5, 1936), supra p. 16 Ronrico Corp. 44 BTA 1130 (1941).

(17) See Rev. Rul. 63-269. In Howkins, 49 T.C. 689 (1968) at p. 693 the Court states: "Petitioner's emphasis upon the sources of income available to him to make these payments and even upon the origin of the actual physical funds used to satisfy his obligation of support misconceives the meaning of the phrase 'income from sources within the United States.'" Congress was not referring here to the origin of the physical means of payment, but rather to the place where the recipient's income was produced."

of income for services is the "situs of the income producing service."⁽¹⁸⁾ In other words, when one searches for the source of income from services, one must consider compensable services. (See §862 (a)(3), I.R.C.) The services for which taxpayer is compensated are undisputed, -- namely, the assembly abroad of (i) foreign hotel space; (ii) ground transportation abroad; (iii) escort service south of the United States border, and (iv) local assistance at taxpayer's offices abroad. Thus, taxpayer earns all its income from sources without the United States.

The reason why in foreign sales transactions the title passage test determines the place of sale for WHTC purposes is that at the moment of title passage the seller has earned his income. Am. Food Products Corporation v. Com., 28 T.C. 14 (1957) at p. 17. The application of the same principle to service transactions is found in Tipton and Kalmbach, Inc. v. United States, 480 F 2d 1118 (CA-10, 1973), a decision referred to by the District Court. In that case a Colorado engineering firm contracted for the design and building of a plant in Pakistan. The contract provided that some of the work would be performed at the engineering firm's office in Denver and some work on the job site in Pakistan. The Pakistan contractor agreed to compensate the engineering firm for both. The court, therefore, found that the engineering firm's income consisted partly of compensation for services within and partly of compensation for services without the United

(18) C.I.R. v. Piedras Negras Broadcasting Co., 127 F 2d 260 (CA-5, 1942). The case is discussed p. 8 *supra* & cited by the District Court. See also Rev. Rul. 70-304, and Howkins, 49 T.C. 689, 693 (1968).

States. The court distinguished the case from Piedras Negras Broadcasting case where all compensable service (as distinguished from solicitation of business) was performed abroad (see supra p.9).

A purchasing agent earns his commission at the place where he makes the purchase. The Commissioner has recognized this where it served his purpose. Rev. Ruling 56-477 dealt with an American purchasing agent who made purchases in the U.S. for South American principals. The foreign principals paid commissions for purchases made in the U.S. The Commissioner ruled that these commissions represented compensation for services in the U.S. and hence from sources within the U.S. for the purpose of applying the source of income test of §921, I.R.C.

VI - THE DISTRICT COURT'S JUDGMENT
IS INCOMPATIBLE WITH THE JUDICIAL PRECEDENTS.

Ever since the enactment of the WHTC legislation the Commissioner has begrudged taxpayers the benefit thereof. He has obstinately sought to limit these benefits. He has done this with ingenious and semi-ingenious arguments which have shifted with the judicial winds but which have consistently been rebuffed by the courts.⁽¹⁹⁾ The present case being one of first impression⁽²⁰⁾ seemed to afford the Commissioner a fresh opportunity to subvert the WHTC legislation,

(19) See the review by A.P.David. The Western Hemisphere Trade Corporation; 10 Harvard Internatl. Law J. 101 (Winter 1969)

(20) Supra p. 2

even though this particular tax incentive is slated for repeal.⁽²¹⁾ The judicial precedents deal mostly with merchandise export transactions, but the teaching of these cases furnish valuable analogies for the decision of the present case.

The distinction between the merchandise export transactions and the case at bar is that in the former, merchandise is transferred from the U.S. to other parts of the Western Hemisphere, whereas taxpayer transfers tourists. This difference is not significant in connection with the source of income issue. Another seeming difference is that in the merchandise transaction the payment for the merchandise is received from the foreign buyer, whereas in the instant case money is collected initially from the American tourist. As was pointed out above, this too is not significant for the determination of the source of income, as most vividly illustrated by the Piedras Negras Broadcasting case (*supra* p. 8). The point is further illustrated by Electric Export Corp. v. U.S., 290 F 2d 923 (Ct. Cl. 1961) involving an exporter of locomotives to Brazil and Chile. The exporter had made a financing arrangement with the Export Import Bank in Washington, D.C. Pursuant to that arrangement, the bank made certain payments to the exporter. Because of that payment, the Commissioner contended that the exporter had failed to meet the 95% source of income test of §109 of the 1939 Code (predecessor statute of §921, I.R.C.). In rejecting this contention the Court said:

(21) Congress contemplates a gradual phasing out of the WHTC. See §1052 of the proposed Tax Reform Act of 1976 (HR 10612, 94th Congress) and U.S. Senate Finance Committee Report thereon, S.Rep. 94-938, 94th Congress, p. 282 seq. It may well be that such repeal is justified because existing tax benefits are too generous, but the courts must apply the statutes as they find them, for which reason the Commissioner's efforts to emasculate §921, I.R.C., have been unsuccessful and should be unsuccessful in the instant case.

"We think the defendant cannot see the forest for the trees ... We believe that the acceptance of defendant's position here would frustrate that commerce between American businessmen and their Latin American counterparts which it was the purpose of §109 to encourage ... It would run counter to this construction of §109 to permit the financing aspect of these contracts to obscure the true source of the interest income .. " (underlining supplied)

In A.P.Green Export Co. v. U.S., 284 F 2d 383 (Ct.Cl. (1960) the sole business of the WHTC consisted of exporting to Canada, Central and South America refractory products which were manufactured by its parent corporation. The Commissioner attacked the corporation's status as a WHTC because, among other grounds, it was an improper tax dodge. The Court rebuffed the Commissioner, citing among other cases, Gregory v. Helvering, 293 U.S. 465 in which the Supreme Court affirmed that it is perfectly legitimate to take advantage of income tax avoidance devices provided by Congress. The Court also rejected the Commissioner's attempt to impose a new criterion for WHTC qualification because it would make it more difficult for a WHTC to qualify for the benefits which are intended for foreign source income.

Frank v. International Canadian Corp., 308 F 2d 520 (CA-9, 1962) involved a rather complex fact situation which for present purposes can be condensed as follows: "Washington", a corporation organized in the State of Washington, manufactured chemicals, some of which it exported to customers in Canada. It then transferred its Canadian export business to "International" a wholly-owned subsidiary organ-

ized in the State of Washington as a WHTC. The Commissioner refused to recognize the export income of International as WHTC income, asserting that this income should be taxed to the parent company. The Court of Appeals affirmed the District Court's holding that International was entitled to the benefits of a WHTC. The principal argument of the Commissioner was that International was not engaged in the active conduct of business (§921, Item 2) because it was a mere conduit for the (manufacturing) parent. In support of this argument, the Commissioner raised almost the same points which he successfully argued in the court below, except that the same points are now raised in connection with the source of income test (§921, Item 1). Because the District Court in the present case was favorably impressed with these points, it seems appropriate to deal therewith in some detail. The Court of Appeals at p. 526/527 specifically refuted the following arguments as being irrelevant to the question as to whether a corporation qualifies as a WHTC:

a) that all activities necessary to the sale of the chemicals were performed by "Washington", the manufacturing parent; "Washington" paid certain persons who opened International's mail, typed order blanks for International and sent one copy of the order to the shipping department and another to the invoicing clerk. Said the Court: "The Commissioner advanced a similar argument in A.P.Green Export Co. v. U.S., but the Court of Claims there held that merely because the parent corporation's employees performed all of the sub-

sidiary's work did not, in and of itself, disqualify the subsidiary as a WHTC."

b) "that International could not be considered as conducting any sales activity, since it had no source of supply [other than its parent], customers, plant or employee organization." The court confirmed previous judicial holdings that a parent organization may transfer its selling operations to an in-house subsidiary who can qualify as a WHTC, citing A.P.Green Export Co. v. U.S., supra, and Barber-Greene Americas, Inc. 35 T.C. 365 (1960).

c) that International had simply taken over an activity which in the previous twenty years had been carried on by its parent. The Court stated: "To qualify as a WHTC, the business of the qualifying corporation need not be restricted to new business developed after its incorporation, i.e., it cannot be said that a WHTC subsidiary cannot be for to take over business previously done by its parent organization. (citations)"

Eli Lilly & Co. v. U.S., 372 F 2d 990 (Ct. of Claims, 1967), is another illustration how an "in house" subsidiary can qualify as a WHTC. The principal problem in that case was the matter of inter-company pricing and the application of §482, I.R.C., which is not an issue in the present appeal.

C.I.R. v. Hammond Organ Western Export Corp., 327 F 2d 964 (CA-7, 1964), is one of the landmark cases. The taxpayer was an in-house subsidiary which was organized for the specific purpose of taking advantage of the WHTC legislation. It exported organs manufactured by the parent corporation to customers in the Western Hemisphere outside the U.S.A. In rejecting the Commissioner's attack on the taxpayer qualification as WHTC, the Court of Appeals said at p. 966:

"The U.S. Court of Claims and the Tax Court have uniformly held that domestic corporations like the taxpayer engaged in export trade from an office in the U.S. satisfy the active trade or business test of §109 and §454(f) of the 1939 Code and §921 of the 1954 Code" ...

"In spite of the solid array of court decisions to the contrary, the Commissioner urges the decision of the Tax Court herein was erroneous ... "

"In effect, the Commissioner is seeking from this Court, a holding which would be in conflict with the decision of every court which has considered the issues here presented ... "

"The statutes do not specify the geographical place where the business is to be conducted ... "

"Congress completely overhauled United States taxation of foreign source income in adopting the Revenue Act of 1962. The avowed purpose

of Congress was to close loopholes which had developed in the tax treatment of income from foreign sources.

As far as we are advised, no proposal was considered to change the WHTC provisions although most of the court decisions hereinbefore quoted had been handed down prior to the adoption of the Revenue Act of 1962 ... it is difficult to understand why a simple amendment to §921 would not have been proposed by the Treasury if there were any merit to the position which the Commissioner has taken in this and similar litigation ... "

In C.I.R. v. Pfaudler Inter American Corp., 330 F 2d 471 (CA-2, 1964) this Court rejected the Commissioner's attempt to introduce his historical animosity to the WHTC into the Second Circuit. Pfaudler was organized as a New York corporation "with the avowed purpose of qualifying as a WHTC to obtain the concomitant tax benefits." (p. 473) The parent granted Pfaudler the exclusive right to sell the parent's product in countries of the Western Hemisphere other than the U.S.

This court stated: "It is not tax avoidance ... to take advantage of a provision of law especially enacted to favor those who do business in a certain area of the world and who otherwise meet the statutory conditions." (p. 474)

The court concluded that there was no reason to depart from the precedents established by the previous court decisions. (p. 473)

Baldwin-Lima-Hamilton Corporation v. United States, 435 F 2d 182 (1970), is another illustration of a WHTC which was organized as an in-house subsidiary and where most of the administrative work is done by the parent's staff. The principal issue in the case was inter-company pricing with which the present case is not concerned.

VII - TAXPAYER'S CONDUCT WAS IN
ACCORD WITH PUBLIC POLICY

This point of the Argument is addressed to the Government's charge that taxpayer's conduct is contrary to public policy, which is not an express issue in this appeal but a "subliminal" issue in the case. As stated in footnote 1, above, the WHTC legislation is one of several provisions of the Internal Revenue Code which confer special benefits to foreign traders.⁽²²⁾ In the Court below the Commissioner went so far as to assert that taxpayer's organization is a sham. This is a favorite clamour in WHTC cases which if litigated has been consistently muted by the Court.⁽²³⁾

(22) Similar I.R.C. provisions are §901, (foreign tax credit); §931 (U.S. possession business); §941 (China Trade); §951, seq., (certain exemptions for controlled foreign corporations, especially trade with underdeveloped countries); §970 (export trade corporation); §991 (Domestic International Sales Corporations) See also Electric Export Co. v. Com., 290 F 2d 923 (Ct.Cl. 1961) as quoted on p. 21.

(23) Barber-Greene Americas, Inc. v. Com., 35 T.C. 365 (1960), A.P. Green Export, supra, Pan American Eutectic Welding Alloys Co. v. Com., 36 T.C. 284 (1961); David, The Western Hemisphere Trade Corp., 10 Harv. Int. L.J. at p. 123

American policy of promoting foreign trade always has the twin objectives of (a) assisting domestic business engaged in foreign trade, and (b) stimulating the economy of our trading partners for the purpose of improving political ties.⁽²⁴⁾ As the court pointed out in the Hammond case (supra, p. 25) these WHTC tax benefits were retained when Congress severely restricted the rules about foreign source income in the Revenue Act of 1962. Now, in the proposed Revenue Act of 1976,⁽²⁵⁾ Congress for the first time seems to veer towards phasing out the WHTC tax benefits for the years after 1976. This is a break with the public policy which prevailed in the years under review in the instant case and which is amply illustrated by the court decisions reviewed above under Point VI.

Taxpayer's business conduct as a WHTC conforms exactly to the twin objectives of the foreign trade tax benefit legislation in that it promoted tourism to the areas south of the Rio Grande, especially the Caribbean countries, where the tourist business is the life blood of the national economy.

In the court below, the Government argued that the expenditure of tourist dollars abroad has an unfavorable influence on the American balance of payment. This may be true, but it is irrelevant. This problem has been dealt with separately, namely, by the enactment of the Interest Equalization Tax, §4911, seq., I.R.C., and the Foreign Direct

(24) Tepper & Lotterman, 31 Cornell L.Q. 205, 207

(25) §1052

Investment Regulations, all of which have now been repealed because the balance of payment problem is no longer a matter of national concern. Indeed, the Secretary of the Treasury recently said that a deficit balance of payment is desirable. (26)

CONCLUSION

ALL OF TAXPAYER APPELLANT'S GROSS INCOME WAS DERIVED FROM SOURCES WITHOUT THE UNITED STATES AND TAXPAYER APPELLANT, THEREFORE, QUALIFIED AS A WESTERN HEMISPHERE TRADE CORPORATION WITHIN THE MEANING OF §921, I.R.C. THE JUDGMENT OF THE DISTRICT COURT SHOULD BE REVERSED AND SUMMARY JUDGMENT FOR TAXPAYER APPELLANT SHOULD BE GRANTED.

Respectfully submitted,

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8/12/76

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